



**DEFENSE CONTRACT AUDIT AGENCY**  
**DEPARTMENT OF DEFENSE**  
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IN REPLY REFER TO

18 May 2000  
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**MEMORANDUM FOR REGIONAL DIRECTORS, DCAA**  
**DIRECTOR FIELD DETACHMENT, DCAA**

**SUBJECT:** Audit Guidance on Final Rule (FAC 97-16) to Revise the Federal Acquisition Regulation (FAR) on Contract Financing

**Background**

This memorandum provides audit guidance regarding the subject final rule. The rule was published in the Federal Register on 27 March 2000 and revises the FAR regarding contract financing payments including progress payments and public vouchers. The final rule is effective for solicitations issued on or after 26 May 2000. A copy of FAC 97-16 can be obtained on the Internet at [http://www.arnet.gov/far/old\\_pdf/frame.html](http://www.arnet.gov/far/old_pdf/frame.html).

Although the revised rule contains several changes, a synopsis of the most significant changes affecting DCAA is as follows:

**Elimination of the "Paid Cost Rule."** Prior to the issuance of FAC 97-16, large contractors were required to pay a subcontractor or vendor before including the payment in their billings (contractor payment requests) to the government. This requirement was referred to as the "Paid Cost Rule." The paid cost rule has been eliminated, and FAR now allows all contractors (large and small) to include, in their billings, subcontractor and vendor costs that have been incurred but not actually paid, provided the payment to the subcontractor or vendor will be made:

- in accordance with the terms and conditions of a subcontract or invoice and
- ordinarily prior to submission of the contractor's next payment request to the government.

The new requirements regarding the timing of including subcontractor/vendor costs in contractor payment requests are contained in the contract clauses at FAR 52.216-7, Allowable Cost and Payment; FAR 52.216-26, Payment of Allowable Costs Before Definitization; FAR 52.232-7, Payment under Time-and-Material and Labor-Hour Contracts and FAR 52.232-16, Progress Payments. The timing of including subcontractor/vendor costs in contractor payment requests is the same for all of the aforementioned contract clauses.

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The Director, Defense Procurement (DDP), in anticipation of the subject FAR revision, issued a memorandum dated 23 September 1999 that recommends elimination of the paid cost rule from existing contracts through Single Process Initiative (SPI) procedures or individual agreements with contractors. Subsequently, the DDP memorandum was superseded by a Defense Contract Management Agency (DCMA) initiative to enter into negotiation with the five largest defense contractors to obtain consideration for elimination of the paid cost rule from existing contracts. If the negotiations are successful at the five largest contractors, DCMA will issue a block modification for these contractors eliminating the paid cost rule from existing contracts. For the remaining large defense contractors, DCMA will, contingent on the results with the five largest contractors, issue a global modification eliminating the paid cost rule from existing contracts. DCMA may require DCAA assistance regarding the negotiation of consideration at the five largest defense contractors. Cognizant FAOs should provide appropriate support if requested by their local DCMA office.

**Elimination of the Limitation on General and Administrative Expenses.** Contractors that had established an inventory suspense account under Appendix A of Cost Accounting Standard (CAS) 410, Allocation of Business Unit General and Administrative (G&A) Expenses to Final Cost Objectives, and whose inventory suspense account was \$5 million or more, were required to limit the amount of G&A expense included in progress payments. This requirement was included at FAR 32.503-7 and FAR 52.232-16(a)(2)(iv). The rule dated from 1979 and only applied to a very few contractors. The final rule eliminates the limitation on G&A expense for contractors that established suspense accounts under CAS 410.

**Fair Value Test for Loss Contracts.** The final rule also clarifies that on a loss contract (FAR 32.503-6f), application of the loss ratio constitutes the adjustment that ensures progress payments do not exceed the value of work performed (fair value test). The purpose of the fair value test is to ensure that there is enough value in the remaining undelivered portion (inventory) of a contract to recover unliquidated progress payments. However, some people had believed that an additional adjustment over and above the loss ratio was needed to preclude an overpayment of progress payments. The revised rule clearly states that the loss ratio adjustment constitutes the fair value test for loss contracts.

## **Audit Guidance**

As part of future billing system audits and reviews of progress payments and public vouchers, auditors should verify that contractors have in place adequate internal controls to ensure that subcontract and vendor costs that have been incurred but not paid are only included in financing payment requests when the contractor makes payments to subcontractors and vendors:

- in accordance with the terms and conditions of a subcontractor or vendor invoice and
- ordinarily prior to submission of the contractor's next payment request to the government.

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Contractors should have the required internal controls in place upon receipt of a contract subject to the revised FAR or upon application of the elimination of the paid cost rule to existing contracts in accordance with any modification to those contracts. As appropriate, auditors should sample paid vouchers and progress payments and ascertain that the contractor has used the revised criteria regarding the timing of including incurred subcontractor and/or vendor costs in contractor payment requests. The number of payment requests reviewed should be based on the results of internal control reviews.

**Closing Remarks**

Field audit office personnel should direct questions regarding this memorandum to personnel in the regional office. If regional personnel are unable to answer or have questions of their own; they should contact Mr. Barry Turner, Program Manager, Policy Program Division at (703) 767-2270.

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